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HOW ENFORCEMENT AGAINST PRIVATE ANTICOMPETITIVE CONDUCT HAS CONTRIBUTED TO ECONOMIC DEVELOPMENT

Contribution from Sweden

-- Session IV --

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PROHIBITION OF FREQUENT FLYER POINTS ON COMPETITIVE DOMESTIC ROUTES – A CASE ON ABUSE OF A DOMINANT POSITION

Executive summary

- The Swedish Competition Authority and the Swedish Market Court prohibited SAS from using its Frequent Flyer Program (FFP) on domestic competitive routes.
- The case illustrates that behaviour that constitutes abuse of dominance, such as predatory pricing and fidelity rebates, is often popular with the dominants' customers.
- Hence, the advocacy role may be particularly difficult for competition authorities that devote a large part of their resources on fighting abuse of dominance.
- According to the Authority's evaluation, which is available in English, this particular FFP increased fares by approximately 10 per cent.

1. On February 27, 2001, the Swedish Market Court partially prohibited Scandinavian Airline System (SAS) from awarding passengers in within its Frequent Flyer Program (FFP). The prohibition became effective as of October 27 the same year. However, the prohibition only applies to *domestic* routes where SAS faces competition from another airline. An econometric evaluation of fares during periods with and without FFPs indicates that the effect of SAS's FFP program was to increase prices by approximately 10 per cent.

2. FFPs have been discussed previously in OECD meetings. For two reasons, the Swedish Competition Authority has chosen to present a case that relates to bonus programs. First, the case highlights the paradoxical situation that abuse of dominance may be perceived by consumers as beneficial. This may, e.g., be the case for fidelity rebates and predatory pricing. Hence, although the prohibition against abuse of dominance is central to competition law enforcement, it is sometimes a challenge to communicate the long-term benefits of such policies. Second, an extensive analysis of the case and the effect of the prohibition on the market is available in English.

1. The Swedish air-travel market

3. The domestic Swedish airline market was deregulated in 1992. Before the deregulation, SAS and its sister/daughter company Linjeflyg held a de facto monopoly position. After the deregulation, a couple of entrants challenged SAS's position. Initially, the entrants were relatively successful, gaining a combined market share of approximately 25 per cent within a few years and putting pressure on prices. However, SAS and its allied regional carrier Skyways regained most of what had been lost, and the pre-deregulation price level was re-established – or even surpassed.

4. Due to Sweden's geography, the domestic air travel market is relatively large – with a total number of passengers corresponding to one third to one half of the domestic passenger volumes in countries like France, Germany, Italy, Germany and Spain. In contrast to those countries, however, the traffic is almost completely concentrated to one national hub – Stockholm. Approximately 97.5 per cent of all passengers have Stockholm as the point of departure or destination, or change aircraft in Stockholm.

5. In 2001, five routes had annual passenger volumes in excess of 400 000 pax, while five additional routes had passenger volumes of at least 200 000 pax. The prevailing view has been that 200-400 000 passengers is enough for at least two operators to be viable on a domestic route.¹

2. Frequent-flyer programs

6. Frequent-flyer programs (FFPs) award passengers with “bonus points” for each paid trip they make. Longer trips give more points and business-fare tickets give more points than leisure-fare tickets of equal length. Bonus points are accumulated on individual accounts. Subsequently, accumulated points can be used for free-of-charge air travels, hotel stays, car rentals et cetera. The ratio between the points earned and the points required for a free trip varies. Typically, the ratio is more favourable for the passenger on long and competitive routes. In Sweden, 5 to 10 business-fare round-trip tickets have yielded enough points to earn a free leisure-class round-trip ticket for a flight of approximately equal length.

7. FFPs were introduced by US carriers in the 1980s and by European carriers in the 1990s. SAS’s bonus program, Eurobonus, was introduced in 1992. When the Star alliance was created in 1997, with SAS as one of the founders, SAS extended its FFP to domestic flights.

8. One of the purposes of FFPs is to make customers loyal to the airline. In order to receive maximum benefit from the bonus offers, the customer has an incentive to concentrate his or her air travels to one airline – or at least one alliance.

9. Bonus programs exist in other industries, such as the food retailing and gasoline retailing. Often, the bonus level is much lower than the typical level found in FFPs. An additional aspect is that points are often earned on flights paid for by the employer, while the points may be used for leisure travels.

3. The competitive assessment of the Swedish Competition Authority and the Market Court

10. An FFP awards a customer’s fidelity towards a single airline (or a single alliance of airlines). In order for a customer to earn sufficient points for a free trip, the customer needs to make a certain number of paid trips with the same carrier before the points begin to expire. This creates a progressivity in FFPs, which is reinforced if the customer values exotic trips relatively more, or wishes to use points for his or her spouse as well.

11. The progressivity, in turn, puts a dominant carrier in a favourable position. If the customer rationally shall concentrate his or her flights to one carrier, in order to derive maximum personal benefit, it is best to choose the carrier that dominates the customer’s local hub. Hence, FFPs serve to reinforce the position of a carrier that is already dominant.

12. SAS, which is in alliance with the regional carrier Skyways and with the other major carriers within the Star alliance, dominates the domestic airline market and the Stockholm/Arlanda hub. SAS’s share of the domestic market was, at the time of the decision, approximately 70 per cent, while Skyways had 15 per cent of the domestic market. In addition, SAS and its international allies had almost 50 per cent of the international traffic to and from Sweden. Between them, the airlines of Star alliance had traffic on almost all of the top 20 international routes (by passenger volumes) from Stockholm, while other alliances were active at, at the most, a handful of the top routes.

13. Relative to bonus programs in many other industries, the market value of the bonus is high. In addition, a large share of the bonus points are generated on trips paid for by the passenger’s employer. At least from a Swedish perspective, this makes FFPs different from methods governing normal competition in products or services based on traders’ performance.²

14. The FFP of SAS had much the same effect as such fidelity-rebate schemes as have been found in violation of Article 82 of the EC Treaty. Given the dominance of SAS and the functioning of the Swedish domestic air-travel market, there was a substantial risk that a continued use of Eurobonus for domestic travels would have eliminated the competition that still remained in the market.

15. On the other hand, it was undeniably the case that from an *international* perspective, the use of an FFP was not unique to SAS, or not even an uncommon practice. Hence, SAS argued that FFPs was an element of normal competition.

16. Largely, the Market Court's reasoning followed that of the authority, although the scope of the prohibition was reduced.

4. The decision

17. In 1998, the Swedish Competition Authority initiated an investigation of the anticompetitive effect of SAS's FFP. Following complaints from one of SAS's competitors, the authority suspected that the bonus system amounted to an abuse of the airline's dominant position on the market for domestic air travel. In its decision, December 12, 1999, the authority established that SAS had indeed violated the Swedish Competition Act, and prohibited SAS from awarding bonus points on domestic trips. However, before the prohibition became effective, the Swedish Market Court inhibited the decision.

18. After court proceedings in the Market Court, the Court found, on February 27, 2001, that SAS's use of an FFP on the domestic market constituted an abuse. The Court *partially* prohibited Scandinavian Airline System (SAS) from awarding passengers in within its Frequent Flyer Program (FFP). The prohibition became effective as of October 27 the same year. However, the prohibition only applies to *domestic* routes where SAS faces competition from another airline.

19. This means that SAS is still able to award passengers FFPs on all international routes, as well as on domestic monopoly routes. (If there is entry on a route where SAS previously was a monopolist, it will immediately have to stop giving FFPs on that route.) In addition, even on competitive domestic routes, SAS can award passengers FFPs, as long as these points cannot be exchange for free trips, hotel stays *et cetera*. In other words, bonus points earned on competitive domestic routes can only be used for upgrading the card status.

5. International positions on FFPs

20. Since August 2002, SAS is prohibited from awarding any points for domestic air travel in Norway. It appears the Sweden and Norway are the only countries that have prohibited FFPs. However, it is generally accepted that FFPs induce loyalty, although some would argue that FFPs may, in spite of this and at least in some circumstances, be pro-competitive. The European Union and Germany have suggested that FFPs can constitute an entry barrier and have, in particular instances, required that incumbents' FFP are opened up to new entrants.

6. The effect of the prohibition

21. The fact that the partial prohibition of SAS's Eurobonus on the Swedish market became effective just a few weeks after September 11, 2001, makes ex-post evaluation more difficult. Immediately after September 11, domestic air fares increased by 3 per cent. However, during the following 12 months, average leisure fares increased, while business fares fell back to the price level of September 1. Although it is difficult to disentangle the effect of September 11, this suggests a relatively more intense competition in the business segment, consistent with what one would expect if loyalty schemes focused on business passengers became less effective.

22. Since autumn 2001, at least four new carriers have entered the domestic Swedish market and the position of the main challenger, Malmö Aviation, appears to have stabilised. There are now at least two carriers on the five routes with the highest number of passengers, as well as on a few smaller routes. In addition, there are some signs of competition between SAS and Skyways.

23. In general, competition in the market appears to have been re-vitalised after the Court's decision. These observations are further underpinned by an econometric study of the effect of the prohibition of Eurobonus which the Swedish Competition Authority commissioned from PhD Fredrik Carlsson, Göteborg University. According to this study, Eurobonus increased the price level by approximately 10 per cent.

24. The study is based on quarterly list prices on individual domestic routes and exploits two regime shifts. In May 1997, Eurobonus was introduced on all domestic routes. In October 2001, Eurobonus was abolished on those routes where SAS faced at least one actual competitor. Although the latter regime shift coincides with the September 11 events, which had implications for the demand for air travel, there is enough variation in the data to enable statistical identification of an effect.

25. The analysis acknowledges that prices and the number of departures are both set by the carriers. Technically, the effect of the FFP is estimated in a 2SLS regression model, which includes up to 15 control variables (distance, population, competition from train et cetera). According to the model, SAS's prices increased by 8 per cent during periods with FFP on competitive routes, while the competitors' prices fell by 4 per cent during these periods. On non-competitive routes, no statistical effect of the FFP was found.

26. Using a completely different econometric technique, the lock-in effect of SAS's bonus program was estimated to be, on average, 500 SEK per business passenger, corresponding to approximately 25 per cent of an average business fare.

7. Discussion

27. The competitive situation on the domestic air-travel market in Sweden was (and is), to some extent, atypical. Due to Swedish geography, passenger flows were concentrated to and from Stockholm, while competition from ground transport is weak on most long-distance routes. Although the dominance of the incumbent airline was not exceptional to Sweden, the fact that SAS was dominant in three neighbouring countries, with large passenger flows between them, is quite exceptional.

28. Relative to other major carriers, a large fraction of SAS's passengers are business passengers. This tends to make an FFP more effective, since business passengers whose tickets are paid for by their employers are likely to give more weight to the personal benefits that can be derived from free bonus travels.

29. Although FFPs are likely to have lock-in effects in most or all market conditions, and although they are under most circumstances likely to contribute towards making entry more difficult, their effects may be less pronounced in other markets. Hence, the decisions taken by the Swedish and Norwegian competition authorities, and by the Swedish Market Court, may be seen as controversial even within the competition community.

30. From a passenger point-of-view, the benefits of a partial or total prohibition of a bonus program may not be evident. At least in the short run, passengers lose a popular benefit, while a more intense competition in prices may only come about in the long run. If the ticket is paid for by the employer, the passenger may perceive a loss even in the long run. According to a research project funded by the Swedish Competition Authority, a clear majority of important Swedish actions against abuse of dominance have focused on behaviour by the dominant which aimed at discouraging customers to abandon the dominant. In many cases, customers were given attractive offers in order to induce loyalty.

31. It is relatively simple to communicate the benefits of detecting, prosecuting and preventing cartels to consumers. However, it may be more difficult to communicate the long-run benefits of policies that are intended to preserve a competitive market situation. In particular, this appears to be the case for enforcement actions against predatory pricing and loyalty schemes, as such behaviour may result in short-term benefits (lower prices, loyalty rebates et cetera) for consumers. Nevertheless, preventing incumbent firms from choking competition is an essential element of competition policy. As suggested by the OECD Secretariat in its background paper, it may even be the most important element of competition enforcement in transition economies.

NOTES

1. In 2001, the Swedish Civil Aviation Authority published a comparative study of eight European domestic markets. In four of the countries, domestic routes with at least 200 000 passengers were in general operated by at least two carriers. In Germany, routes with at least 400 000 passengers were in general competitive, while Finland, France and Sweden appeared, at that time, to be the least competitive domestic markets of those included in the sample.
2. Cf. the definition of abuse, as expressed by the EC Court in *AKZO* (62/86) [1991] E.C.R.I-3359, para. 70.